



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

UIL No.

170.07-06

501.03-00

509.00-00

512.00-00

513.00-00

7701.01-00

Legend:

A =

B =

C =

LLC =

Dear _____ :

This is in reply to your request for a ruling concerning the proposed merger of C into LLC.

Facts

You are an organization described in section 501(c)(3) of the Internal Revenue Code and a public charity described in sections 509(a)(1) and 170(b)(1)(A)(vi). Your amended Articles of Incorporation state that your purposes are to conduct scientific research, study, train and disseminate information regarding the disease A, and to provide indirect patient services to victims of A. Accordingly, you provide research, medical treatment and financial support regarding the cure and control of A and provide emotional support to persons diagnosed with A.

As part of your activities, you have set up treatment centers, known as B, at major teaching and community hospitals throughout the country, which provide diagnostic services and comprehensive treatment for people with A, although you do not own or operate B. Physicians at B must follow your strict medical standards for treatment of patients in order for you to financially support B. Patients at B often volunteer for clinical trials for new treatment methods. You maintain a patient registry to use in A research, and most of the data is derived from B.

You own 100 percent of C, a for-profit corporation. C's sole activity is to operate and manage a national Internet-based specialty pharmacy (the "Pharmacy") that sells A-related prescription pharmaceuticals, A-related durable medical equipment, and non-prescription A-related vitamins and A-related supplements (collectively, "A-Related Products"). The Pharmacy serves persons who have been diagnosed with A. The Pharmacy services a large percentage of the A patients

in the United States and is approved as a provider by many insurance plans and by most state Medicaid programs. You state that the Pharmacy maintains a large inventory of A-Related Products that are either too specialized for other pharmacies to profitably stock or that are exclusive products sold only by the Pharmacy. The Pharmacy also helps A patients receive insurance reimbursement for these pharmaceuticals. The Pharmacy maintains a website through which it carries on these activities.

You have provided documentation that many commercial pharmacies, including Internet-based pharmacies, do not stock A-Related Products because many must be refrigerated, delivered in cold packages, and are too expensive to purchase and hold in inventory. You also provided information that commercial pharmacies provide many A-Related Products only through special ordering, resulting in substantial delays before they can be delivered to A patients. You maintain that such delay poses substantial health risks to A patients who need these items on a timely basis. You state that all A-Related Products are immediately available through the Pharmacy by overnight shipment. You maintain that commercial pharmacies often do not have the necessary expertise concerning all A-Related Products to serve A patients proficiently and expeditiously. You also state that some commercial pharmacies have referred A patients to the Pharmacy to buy A-Related Products.

All of the Pharmacy's sales are derived from the sale of A-Related Products. Although not required by law, the Pharmacy does not sell any A-Related Product without a doctor's prescription. The Pharmacy does not sell non-medical items and sells certain A-Related Products exclusively. The Pharmacy receives nearly all of its prescription referrals from doctors working at B. Anyone diagnosed with A having a prescription may purchase A-Related Products from the Pharmacy. All A-Related Products the Pharmacy sells that are required to have FDA approval have such approval, although not all of the products it sells require such approval.

The Pharmacy assists A patients in obtaining third-party insurance payments and acts as an advocate for A patients to assist in obtaining insurance coverage of A-Related Products. The Pharmacy's employees have the knowledge and expertise in dealing with insurance companies to assist A patients so they can receive the A-Related Products quickly and in a cost-effective manner. While an A patient seeks insurance coverage or other third-party reimbursement, the Pharmacy carries open accounts receivable from A patients without charging interest. The Pharmacy also participates in Patient Assistance Programs operated by several pharmaceutical companies that manufacture A-Related Products. These programs provide free medications to individuals who meet specific criteria for assistance. The Pharmacy also provides free emergency supplies of A-Related Products to patients who may have periodic lapses in their insurance coverage.

The Pharmacy makes charitable and educational contributions for A patients. It provides direct financial assistance to help patients purchase their A-Related Products. It also contributes educational grants and makes other contributions to support an annual conference on ways to treat and cure A. The Pharmacy contributes to drug research and clinical trials directed toward finding new pharmaceuticals to improve the quality of life of A patients.

Recently, you reviewed the structure and operation of C and the Pharmacy. Based on this review, you concluded that by realigning your corporate structure, you would realize significant improvements in efficiency and productivity, which would benefit A patients. As a result, you formed LLC, a limited liability company under state law, of which you are the sole member. You propose to merge C into LLC. Thereafter, LLC will continue to operate the Pharmacy previously operated by C in the same manner as C and will carry on the same charitable activities as C. Thus, LLC will sell only A-Related Products and A-related services exclusively to individuals who have been diagnosed with A and who are patients at a B.

You have represented that LLC will not file Form 8832 to elect under section 301.7701-3(c) of the Income Tax Regulations to be classified other than as a disregarded entity under section 301.7701-3(b)(1)(ii) of the regulations.

You have also represented and acknowledge that section 337(b) of the Code applies to the merger of C into LLC, and that following the merger, you, C and LLC will comply with the requirements of section 337(b) and section 1.337(d)-4 of the regulations, including the payment of any applicable federal income taxes.

Rulings Requested

1. The merger of C into LLC will not adversely affect your current status as an organization described in section 501(c)(3) of the Code.
2. LLC's sales of A-Related Products will not generate unrelated business taxable income to you under section 512 of the Code.

Law

Section 501(a) of the Code provides an exemption from federal income tax for organizations described in section 501(c)(3).

Section 501(c)(3) of the Code describes organizations that are organized and operated exclusively for one or more exempt purposes, such as charitable, educational or scientific purposes.

Section 1.501(c)(3)-1(d)(2) of the regulations states that the term "charitable" as used in section 501(c)(3) of the Code, is to be construed in its generally accepted legal sense.

Section 511(a) of the Code imposes income tax on the "unrelated business taxable income" of organizations exempt from taxation under section 501(a), including those organizations described in section 501(c)(3).

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived by any organization from any "unrelated trade or business"

regularly carried on by it, less the deductions directly connected with the carrying on of such trade or business.

Section 513(a) of the Code and section 1.513-1(a) of the regulations state that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related to the exercise or performance by the organization of its charitable, educational or other exempt purpose or function that constitutes the basis for its exemption under section 501 of the Code.

Section 1.513-1(b) of the regulations provides that for purposes of section 513 of the Code, the term "trade or business" has the same meaning as in section 162, and generally includes any activity carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(b) of the regulations also provide that these activities do not lose their identity as a trade or business merely because they carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the organization's exempt purposes. For example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose its identity as a trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital consistent with its exempt purposes or in compliance with section 513(a)(2) of the Code.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of the organization's exempt purpose. This regulations also provides that a trade or business is "substantially related" only if the causal relationship is a substantial one. Thus, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of the organization exempt purposes.

Section 301.7701-3(b)(1)(ii) of the regulations provides that for federal tax purposes, an entity with a single owner, unless it otherwise elects, is disregarded as an entity separate from its owner.

Section 301.7701-3(c) of the regulations provides that an such an entity may elect to be classified other than as a disregarded entity under section 301.7701-3(b)(1)(ii) by filing Form 8832.

Rev. Rul. 78-435, 1978-2 C.B. 181, involved a hospital that provided various rehabilitation services to handicapped persons, including those with hearing deficiencies. The organization tested and evaluated the hearing of individuals with hearing deficiencies, and recommended the types of hearing aids as may be necessary in each case. Individuals could purchase hearing aids from the organization. If they did, the organization fitted the hearing aids to insure maximum assistance to the individuals in the correction or alleviation of their hearing deficiencies.

This ruling concluded that the sale of hearing aids as an integral part of an organization's program to test and evaluate individuals with hearing deficiencies contributed importantly to its tax-exempt purpose of promoting the health of such persons. Therefore, under these circumstances, the sale of hearing aids was substantially related to the purpose constituting the basis for the organization's exemption and was not an unrelated trade or business or business within the meaning of section 513 of the Code.

Analysis

Ruling No. 1

You are an organization described in section 501(c)(3) of the Code. Accordingly, you provide research, medical treatment and financial support regarding the cure and control of the disease A and provide emotional support to persons diagnosed with A. Following the proposed merger of C into LLC, you will continue to carry on these same activities.

In Ruling No. 2, we conclude that LLC's Pharmacy activities will not constitute an unrelated trade or business within the meaning of section 513(a) of the Code because they will contribute importantly to the achievement of your tax-exempt purposes within the meaning of section 1.513-1(d)(2) of the regulations. Thus, following the proposed merger, your current activities, together with LLC's Pharmacy activities, which will be treated as a component part of your activities, will continue to further your tax-exempt purposes within the meaning of section 1.501(c)(3)-1(d)(2) of the regulations. Therefore, the proposed merger will not adversely effect your current status as an organization described in section 501(c)(3) of the Code.

Ruling No. 2

Section 511(a) of the Code imposes a tax on the "unrelated business taxable income" of organizations exempt from taxation under section 501(a), including those organizations described in section 501(c)(3).

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived by any organization from any "unrelated trade or business" regularly carried on by it, less the deductions directly connected with the carrying on of such trade or business.

The term "unrelated trade or business" means any "trade or business" the conduct of which is not substantially related to the exercise or performance by the organization of its charitable, educational or other exempt purpose or function that constitutes the basis for its exemption under section 501 of the Code. See section 513(a) and section 1.513-1(a) of the regulations.

The term "trade or business" has the same meaning as in section 162 of the Code. It generally includes any activity carried on for the production of income from the sale of good or performance of services. Thus, the sale of goods does not lose its identity as a "trade or business" merely because this activity is carried on within a larger context of activities that are related the organization's exempt purpose. See section 1.513-1(b) of the regulations.

Section 1.513-1(d) of the regulations provides that a trade or business is substantially related to an exempt organization's tax-exempt purposes if contributes importantly to the accomplishment of the organization's tax-exempt purposes. For example, in Rev. Rul. 78-435, supra, the sale of hearing aids by a tax-exempt healthcare organization, which was an integral part of its program to test and evaluate individuals with hearing deficiencies, contributed importantly to its tax-exempt purpose of promoting the health of such persons.

Following the proposed merger of C into LLC, you will be the sole member of LLC. Therefore, under section 301.7701-3(b)(1)(ii) of the regulations, LLC will be disregarded as an entity separate from you. You have represented that LLC will not file Form 8832 to elect under section 301.7701-3(c) to claim classification other than as a disregarded entity under section 301.7701-3(b)(1)(ii). Thus, following the proposed merger, all of LLC's activities will be treated as a component part of your activities.

Following the proposed merger, LLC will continue to operate the Pharmacy previously operated by C in the same manner as C and will carry on the same charitable activities as C. Thus, LLC will provide only A-Related Products and A-related services exclusively to Individuals who have been diagnosed with A and who are patients at a B.

Therefore, although LLC's Pharmacy will be treated as a component part of you, it will not lose its separate identity and will constitute a separate "trade or business." Section 1.513-1(b) of the regulations.

Your amended Articles of Incorporation state that your purposes are to conduct scientific research, study, train and disseminate information regarding the disease A, and to provide indirect patient services to victims of A. Therefore, similar to the organization in Rev. Rul. 78-435, supra, LLC's Pharmacy will contribute importantly to the achievement of your tax-exempt purposes within the meaning of section 1.513-1(d)(2) of the regulations. As a result, the Pharmacy will not constitute an unrelated trade or business within the meaning of section 513(a) of the Code.

Rulings

1. The merger of C into LLC will not adversely affect your current status as an organization described in section 501(c)(3) of the Code.
2. LLC's sales of A-Related Products will not generate unrelated business taxable income to you under section 512 of the Code.

This ruling is based on the understanding there will be no material changes in the facts upon which it is based.

This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides it may not be used or cited by others as precedent.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Steven B. Grodnitzky
Manager
Exempt Organizations
Technical Group 1

Enclosure:
Notice 437